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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936.

No. 389

THE KNOX NATIONAL FARM LOAN ASSOCIATION, A CORPORATION, AND THE FEDERAL LAND BANK OF LOUISVILLE, A CORPORATION,

Petitioners,

vs.

ARTHUR C. PHILLIPS,

Respondent.

BRIEF ON BEHALF OF RESPONDENT.

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Of Counsel:

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HENRY C. DEVIN,
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Statement of Facts.

Respondent adopts the statement of facts set forth on pages 2-10 of Petitioners' Brief, with the following suggestions:

First. That in using the term "insolvent", as descriptive of the status of the Association, it is intended to indicate impairment of capital. As shown by Petitioners' Brief, page 6, a deficiency of current assets [illegible] the Association's capital stock account [illegible], leaving the book value of all outstanding stock [illegible] of par.

Second. The proceeding initiated by the filing of the original complaint was in equity and prayed equitable relief [illegible]. As such the final decree now for review was based

upon the original petition, plus such supplementary matters as transpired during the progress of the suit, and which by proper proceeding were made a part of the record. Under an appropriate interlocutory order, respondent paid in cash the balance of $265.00 necessary to complete a full cash payment to the Federal Land Bank, whereupon the mortgage was released of record and no issue remained in this litigation between respondent and the Federal Land Bank, an original defendant, and that Bank thereupon cancelled its shares in that amount issued to the Association, and under the terms of its collateral agreement applied the par value of those shares to the Association's general indebtedness to the Bank. It does not appear, so far as we have been able to learn from the record, what disposition the Association made of its shares issued to the respondent, and which were retained by the Association when the loan was made under a receipt issued to him by the Association, containing the following provisions:

> (a) "This stock is being held by this association pursuant to the provisions of the Federal Farm Loan Act, as collateral security for the payment of the loan."
>
> (b) "Notice to borrower.—This receipt represents your investment in stock on which dividends will be paid. It will be accepted at face value on final payment of loan" (R. 71).

It does not appear from the record whether any other National Farm Loan Association issued receipts of similar tenor.

The Questions Involved.

1. Do the provisions of Sections 721 and 733 of the Federal Farm Loan Act, providing (a) that when the Bank receives payment in full for its loan the stock in the Bank issued to the Association "shall be paid off and retired", and that "in such case the National Farm Loan Associa-

tion shall pay off at par and retire the corresponding shares of its stock which were issued when said Land Bank stock was issued": and (b) the provisions of Section 733 dealing with the purchase and retirement of Association stock issued to individuals that "said capital stock shall be paid off at par and retired upon full payment of said loan", are operative when the book value of the stock is less than par?

2. Whether the contract evidenced by the receipt, whereby the Association agreed that the stock would be accepted at face value on final payment of the loan, has been breached, does respondent thereby have a right of action for the breach to the extent of the par value of the stock?

3. If such a contract creates rights in the stockholder additional to those accorded by the Act, is it *ultra vires* as to such excess?

4. Can an Association, which continues to engage in the business of making new loans, selling its remaining capital stock at par, urge in defense of this action the unfairness to other stockholders of the redemption of this stock at par?

5. Respondent's stock having been pledged as collateral security for *his* loan, which has now been paid, is, unless the provisions of the Act for the cancellation and redemption of that stock are applicable, entitled to receive his shares and remains a stockholder of the Association. The same situation will exist as to succeeding borrowers when their loans are liquidated. Is it the intent of the Farm Loan Act to permit these Associations to be managed and perhaps controlled by groups of stockholders who have ceased to be borrowers?

6. Are the provisions of Section 961 of the Act covering the dissolution and liquidation of National Farm Loan

Associations exclusive or cumulative to the exercise of such jurisdiction by the Courts, and if exclusive should such Associations be conclusively deemed solvent until their operations are terminated by a finding of insolvency by the Farm Credit Administration?

Argument.

1. The main question presented by Petitioners' Brief is the construction of Section 721 and Section 733 of the U. S. Code, originally enacted in the Federal Farm Loan Act, Section 721 provides for the subscription to stock of the Federal Land Bank by the Association to the amount of five per cent of each loan, provides that such stock shall be held by the bank as collateral "for the repayment of said loan" and contains a mandatory provision that it shall be paid off and retired upon the full payment of the particular loan. It then requires that "in such case the National Farm Loan Association shall pay off at par and retire the corresponding shares of its stock which were issued when said Land Bank stock was issued."

Section 733 relates to membership in the Association. It provides that "no persons but borrowers on farm land mortgages shall be members or shareholders of National Farm Loan Associations." It then provides for the sale of stock to borrowers in an amount of five per cent of their loans. Such stock is to be held as collateral security "for the repayment of said loan", but borrowers receive dividends while the stock is outstanding. It provides that "said capital stock shall be paid off at par and retired upon full payment of said loan."

These provisions must be given effect in determining the intent of Congress. From them we deduce: (1) That it was intended to equalize and correlate the stock issued by the Land Bank to the Association and that issued by the Association to the individual. (2) That the operation of the

Association was to be mutual. Its management was by other provisions of the law entrusted to its stockholders who have full voting powers as usual in corporations. It therefore provides that no persons other than borrowers shall be members or shareholders. The relation between this provision and the mandatory redemption of stock when a stockholder ceases to be a borrower is obvious. The stock in the Association is held as collateral by the Association, but voted by the members. It is held solely as security for the individual loan owing by its stockholder. When that loan is paid the Association can no longer retain the collateral. If the Association continues in business, as this Association is now engaged, making new loans and receiving full payment of its loans, but unable or unwilling to cancel and redeem its outstanding stock, a situation will inevitably arise whereby its management will be controlled by stockholders who are not borrowers and the mutuality of the Association will be destroyed.

We understand that this supposition may be contraverted by counsel for petitioners, who take the position that although the loan is paid in full and the stock in the Association is not redeemed, the stockholder has ceased to be a stockholder and will be unable to exercise his right to vote the shares standing in his name. This position is, however, untenable. A corporation cannot cancel stock, which is merely evidence of the shareholder's ownership of a proportionate interest in the corporation, and prevent the exercise of the rights of the shareholder in the management of the corporation, without paying him the value of his shares under some adequate provision of law authorizing stock redemption. If the provisions of the Act directing the Association to redeem the stock at par are inapplicable, as petitioners claim, because Congress did not intend this provision to apply to cases involving impaired capital, then

the related and dependent provisions are inapplicable and there can be no redemption, there can be no cancellation, and respondent remains a shareholder entitled to his proportionate voice in the management of the corporation.

It is inconceivable that Congress should have intended to impose upon a shareholder under such conditions a possible loss of the full book value of his stock, and, as of the date the Act was passed, a double liability to creditors of the Association, prohibit his sale of the stock, render it impossible for him to cease to be a shareholder, involve him in future operations of the company which might result disastrously, but deny him a voice in its affairs.

We have not referred to the cases dealing with this subject because we believe that they are answered by the foregoing considerations in so far as they support the petitioners' claim.

2. In addition to the provisions of the statute, this particular Association issued a receipt for this stock which constituted a contract between the parties. The opinion of the Court of Appeals, now under review, was based specifically upon the theory that the judgment for $265.00 entered against the Association was properly based upon this contract.

The only defense to this claim is apparently that such a contract, if exceeding the provisions of the Act, would be *ultra vires*.

It does not appear whether such contracts were entered into by other Associations with their stockholders, or by this Association with other individual stockholders. Whether the decision of the question in this case will affect other cases is uncertain. It was peculiarly within the province of the State Court to consider this question of contract and the opinion below shows that it was very thoroughly considered. We submit this phase of the case upon the opinion of that Court.

3. The Association has continued in business, making new loans and selling its capital stock to new borrowers at par. We are advised that more than $100,000.00 in loans have been made during the pendency of the present suit. It is urged by the petitioners that to redeem respondent's stock at par would be unfair and is not contemplated by the Act because its book value is slightly less than par. It might with equal justice be urged that the Association could not continue to sell its stock at par to present borrowers, and certainly whatever unfairness might result to existing stockholders from the redemption of respondent's stock at par would be exactly equalized by the sale to a new borrower of the same number of shares at par.

An examination of this law forces one to the conclusion that regardless of the actual book value of the stock of the Land Bank or of the Association, and whatever dividends these stocks may pay, and whatever the actual value may be, Congress has adopted a policy of fixing par as a basis for the sale and redemption of the stock and so long as the Association continues in the business of making loans, the complicated system of accounting and credit is based upon the fictitious par value, and that the purchaser is by the mandatory provision of the law required to buy his stock at this value, whether it is worth fifty per cent or two hundred per cent of par, open market sales of stock are absolutely barred, and redemption must be at the same fictitious value.

In conclusion, and bearing directly upon the foregoing, is a question which is fundamental in this case, to-wit, what effect must be given the provision of the Federal Farm Loan Act (Section 961, U. S. Code), covering the matter of insolvency and receivership? That section is found in full on page 81 of "The Laws Pertaining to Farm Mortgage Loans", filed as an appendix to the petitioners' brief. It provides that upon the conditions set forth therein the

Farm Credit Administration may declare such Associations insolvent, appoint a receiver, and that the affairs of the Association shall be liquidated. Obviously, portions of this Section were taken from the corresponding provisions of the National Banking Law, giving similar power to the Comptroller of the Currency. It is admitted that this Association has not been found to be insolvent by the Administration, although in the present case it was stipulated that the Association is insolvent. Apparently no claim is asserted here by petitioners that the jurisdiction of the Administration was exclusive, and that the Court had no power to make this finding. We therefore assume that since the petitioners represented by the law offices of the Federal Farm Administration have stipulated and rely upon the fact in this record, that the Court of the first instance properly found that the Association was insolvent, they have waived the immunity from judicial control over this issue which is fundamental in cases dealing with the similar provisions of the National Banking Law.

In conclusion, counsel respectfully state that their employment to prepare this brief occurred within the last few days and that the brief for the petitioners was filed so recently that a review of authorities is impossible.

Respectfully submitted,

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